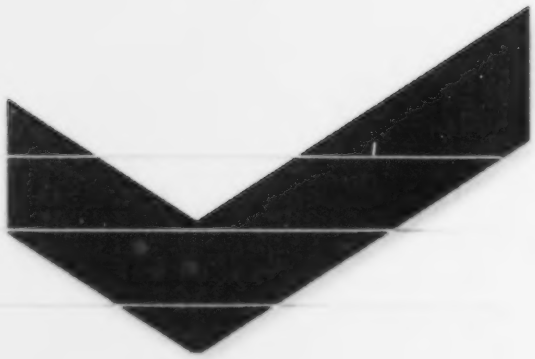
A Balanced Approach to Surplus and Debt Management



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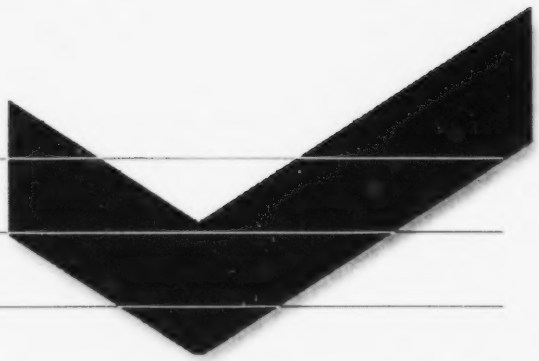

NOVA SCOTIA
Department of Finance

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Introduction

The Government of Nova Scotia has made a commitment to getting its financial house in order by delivering a balanced budget in fiscal 2002–03. Achieving a balanced budget is a very important first step on the road to achieving long-term fiscal sustainability for Nova Scotia.

The second step toward achieving fiscal sustainability is to generate larger surpluses. Larger surpluses will reduce the level of net direct debt of the province, which will lead to reduced debt-servicing costs and more flexibility for government. Reduced net direct debt coupled with increased economic growth leads to a decrease in the net direct debt to gross domestic product (GDP) ratio. As a province's net direct debt to GDP ratio decreases, the sustainability of a province increases.

This paper is a discussion of the importance of achieving annual surpluses for the Province of Nova Scotia, the impact of capital spending on Nova Scotia's debt, the benefits of managing our debt, and the relationship between all three factors.

What is the difference between deficit and debt?

Most Nova Scotians live within their means and believe their government should, too. That means, no more deficits.

Simply stated, a deficit is a shortfall in revenue over expenses that occurs over a period of time, usually one year. Debt is the total of what you owe. Debt includes everything that you have borrowed for either capital assets or to finance day-to-day living. Just like a household or a business, government cannot indefinitely continue to add to its debt without an increase in its ability to repay that debt. As the debt increases, it becomes more costly to service that debt. The more you owe, the higher your interest charges climb. Plus, the lenders whose investments finance the debt, see a higher risk and demand an even higher interest rate.

For a household, the surplus or deficit would be your bank balance after you have paid your mortgage or rent, car payment, transportation costs, groceries, utility bills, clothes, credit card charges, and living expenses. Your debt would be the amount that you owe on your house, car, personal line of credit and credit cards. Table 1 illustrates the difference between the two terms for a household and government.

Table 1

Illustration of Deficit and Debt

Terms	Household	Government (2001–02 Forecast)
Revenue	Monthly Pay Cheque	Provincial taxes Federal transfers Income from Crown Corporations
	Total: $2,500	Total: $5.174 billion
Expenses	Mortgage/rent Car/transportation Groceries Utilities Clothes Other living expenses Credit card payment	Health Education Community Services Transportation Other departments (Amoritization is included in departments) Debt-servicing costs (interest)
	Total: $2,800	Total: $5.280 billion
Deficit	$300 overdraft	$106.3 million
Debt	Mortgage outstanding Credit card balances Line of credit balance Balance owing on car	Sysco debt NSRL debt Capital borrowing Borrowing for operations (fund the deficit)
	Total debt: $100,000	Total net direct debt: $11.5 billion

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What is net direct debt?

A term that is commonly used when discussing a government's fiscal health is net direct debt. Net direct debt is the total of all accumulated deficits and surpluses, offset by certain assets of government. Another way to think of it is as the retained earnings of a business or an individual's net worth. It is one way to measure the financial health of the province rather than simply focusing on the debt that is owed.

The province's net direct debt is affected by its change in financial position at the end of the year. Did the government record a surplus or a deficit? How much capital spending (meaning cash spent on capital assets, such as roads, schools, infrastructure) was incurred in the year? Was the capital spending greater than the amount of amortization expensed in the fiscal year?

The activity around capital spending is important, because a government can be recording surpluses at year-end, however the net direct debt can continue to increase if capital spending is greater than the combined total of the surplus and the amortization costs. This is the current situation with Nova Scotia. Table 2 illustrates Nova Scotia's projected net direct debt to 2005–06. Results reported in Table 2 reflect the worst case scenario for the province, which is that the budgets are just balanced and no surpluses are recorded.

Table 2

Nova Scotia's Projected Net Direct Debt

All numbers expressed in millions

	Forecast 2001–02	Estimate 2002–03	Estimate 2003–04	Estimate 2004–05	Estimate 2005–06
Beginning net direct debt	11,348.3	11,537.7	11,638.1	11,740.9	11,833.7
Add (deduct): Deficit/(surplus)	106.3	(1.3)	0.0	0.0	0.0
Add: Increased capital spending	186.0	218.9	230.0	230.0	230.0
Less: Amortization	(102.9)	(117.2)	(127.2)	(137.2)	(147.2)
Ending net direct debt balance	11,537.7	11,638.1	11,740.9	11,833.7	11,916.5

Source: Budget Address 2002–03, Schedule 19.

While the net direct debt increases, even with balanced budgets, there is an increased investment in infrastructure (roads, schools, hospitals) that will provide services for many years to come. Similarly, a household's debt may increase; however, if that debt is used for household assets (house, vehicle) then the household's net worth is maintained. Nova Scotia's net direct debt in 2000–01 of $11,348 million was made up of $2,668 million to fund capital assets and $8,680 million to pay for past operating deficits.

Why should government be concerned about its level of net direct debt?

The province's financial health is determined not by the actual dollar value of net direct debt, but rather by the net direct debt relative to the ability to repay the debt while sustaining existing and future programs.

A similar situation exists for a household. The amount of debt a household can carry is determined by the ability to repay the debt; for example, the ability to repay may be determined by annual income. If a household's ability to repay increases—they receive a raise—there is an opportunity to carry more debt.

For the purposes of this paper the focus will be on net direct debt relative to gross domestic product (GDP). The ratio is commonly used by governments and credit rating agencies as a measure of the financial health of the provinces.

The net direct debt to GDP ratio is a measure of sustainability. A rising net direct debt to GDP ratio means that the burden of debt on the taxpayers is becoming more onerous. In 1990–91 Nova Scotia's net direct debt to GDP ratio was 27.9 per cent. In 2000–01 Scotiabank's economic group had forecast that Nova Scotia's net direct debt to GDP ratio would be 46.2 per cent, while the median of Canadian provinces was 30 per cent. The trend in Nova Scotia is not sustainable.

By achieving balanced budgets Nova Scotia has taken the first step toward changing the trend and reducing the net direct debt to GDP ratio. Using the net direct debt balances from Table 2, it is estimated that the province's net direct debt to GDP ratio will be 41.7 per cent in fiscal year 2005–06. See Table 3 for the projected net direct debt ratio from fiscal 2001–02 to fiscal 2005–06.

Table 3

Projected Net Direct Debt to GDP Ratio

All numbers expressed in millions

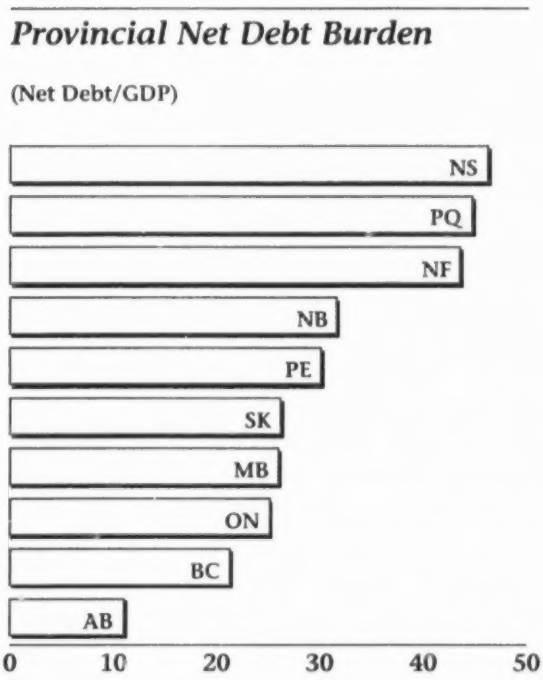
	Forecast 2001–02	Estimate 2002–03	Estimate 2003–04	Estimate 2004–05	Estimate 2005–06
Net direct debt balance	11,537	11,638	11,740	11,833	11,917
Gross domestic product (current dollars)	24,925	25,288	26,668	27,651	28,601
Net direct debt to GDP Ratio	46.2%	46.0%	44.0%	42.8%	41.7%

Source: Department of Finance, Economic Division, and Budget Address 2002, Schedule 19.

At 46.2 per cent, Nova Scotia has the highest provincial net direct debt to GDP ratio in the country. When looking at the net direct debt to GDP ratio of the other provinces, the majority of provinces are in the range of 21 per cent to 26 per cent. A 25 per cent ratio would have Nova Scotia comparing favourably to Ontario, Manitoba, and Saskatchewan. A target net direct debt to GDP ratio equal to the median of 30 per cent would put Nova Scotia in the range of Prince Edward Island and New Brunswick. See Graph 1 for a comparison of Nova Scotia debt to GDP ratio.

Graph 1
The graph shows the provincial net debt burden, with the Province of Nova Scotia having the highest debt/GDP ratio.

The chart was constructed with Moody's data and Scotia McLeod estimates and was circulated in the Scotia Economics report *Fiscal Pulse: The Provincial Budgets ... Caution in 2001.*



Source: Scotia Economics Fiscal Pulse: The Provincial Budgets ... Caution in 2001

What are the benefits of reducing our debt?

The imperative to reach a balanced budget is driven by the need to reduce the province's net direct debt to GDP ratio and eventually its overall debt burden. It is the costs associated with maintaining the debt that continue to limit the choices available to government. Over the last 10 years the government of Nova Scotia paid $7 billion in debt-servicing costs. In 2002–03 the gross debt-servicing costs are estimated to be just over $1 billion. These costs are offset by sinking fund earnings resulting in net debt-servicing costs of $865 million. In order to achieve fiscal sustainability and increase the choices available to government, the province's level of debt must be reduced.

Nova Scotia's gross debt-servicing costs as a percentage of revenue is forecast to be 19.1 per cent in fiscal 2001–02. Scotia Economics *Fiscal Pulse* April 2002 reports that the average gross debt-servicing costs to revenue ratio for all provinces is 12 per cent.

Debt reduction, and the resulting lower debt-servicing costs, can be achieved only by generating cash surpluses. Cash surpluses will allow the government to reduce the amount of debt, which will lead to decreased debt-servicing costs and to increased available dollars for other policy objectives of government.

Debt management is important in that it affects the credit rating of the province. When evaluating or rating the creditworthiness of a province, rating agencies take into consideration a number of factors. These factors include the fiscal strength of the government, projected borrowing requirements, percentage of own-source revenue relative to federal transfers, the diversity of the economy, projections for economic growth and employment, the government's ability to achieve its fiscal targets, and the government's fiscal policies.

In Moody's Investors Service latest analysis, dated December 2001, of the creditworthiness (or rating) of the Province of Nova Scotia, they directly relate the rating that the province received to its above-average debt burden. While the province has made a number of significant improvements in the areas of more comprehensive financial reporting, program consolidations, cost cutting, and reducing the size of government, the net direct debt is still closely monitored by the investment community.

Improving the province's credit rating is a key financial objective of the government. See Table 4 for a ranking of provinces by credit rating.

Table 4

Provincial Credit Ratings

Legend
DBRS—highest rating is AAA (high)
S&P—highest rating is AAA+
Moody's—highest rating is AAA

	DBRS	S&P	Moody's
Newfoundland	BBB	A-	Baa1
Prince Edward Island	A(low)	Not rated	A3
Nova Scotia	BBB+	A-	A3
New Brunswick	A	AA-	A1
Quebec	A	A+	A1
Ontario	AA(low)	AA	Aa3
Manitoba	A	AA-	Aa3
Saskatchewan	A	A+	A1
Alberta	AA(high)	AAA	AAA
British Columbia	AA(low)	AA-	Aa2

Source: Nova Scotia Department of Finance, Annual Survey, March 2001

Why can't government simply increase revenues?

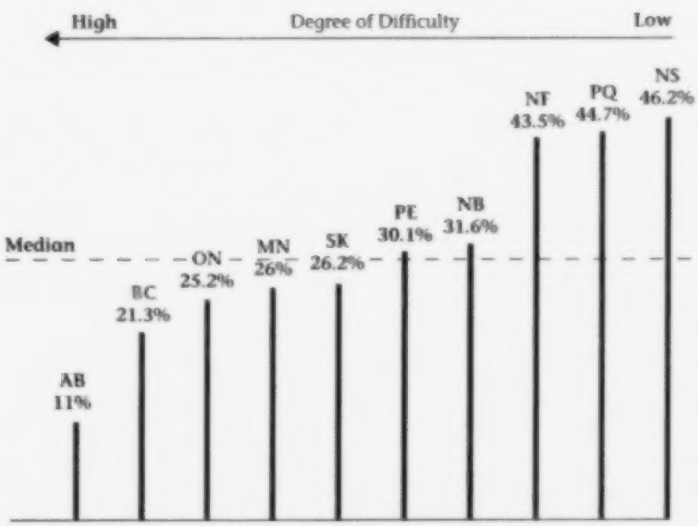
Increasing revenues through excessive taxation stifles economic growth. Companies would not want to locate in Nova Scotia because of the high cost of doing business; unemployment would rise; people would have less confidence in the economy and would spend less. The result would be lower income tax and sales tax revenue. Lower revenues would ultimately affect government's ability to deliver programs and services to the public.

What steps can Nova Scotia take to reduce its debt burden?

Government can reduce its debt burden by either reducing its net direct debt or growing its economy, or a combination of both. Each option has impacts and requires decisions of government. Increasing annual surpluses requires tough decisions about the services Nova Scotians rely on. Similarly, reducing capital spending directly affects the facilities needed to deliver services to Nova Scotians. The impacts will be determined by the targeted level of debt the province should have and how soon do we want to achieve those targets. Graph 2 illustrates Nova Scotia's position relative to the other provinces in Canada and the degree of difficulty in moving toward a targeted net direct debt to GDP ratio.

Graph 2

Provincial Comparison of Net Direct Debt/Gross Domestic Product Ratio, 2000–01



Source: Data from Scotiabank, Economics Group for Fiscal Year 2000–01.

A balanced approach

The first, most important step will be taken with achieving a balanced budget. Government must continue to deliver balanced budgets as required by the Provincial Finance Act as amended by the Financial Measures Act. The requirement to balance and be accountable with government funds extends to district health authorities and school boards. Additional accountability measures will be brought forward to reinforce the need to properly manage and account for all provincial public funds.

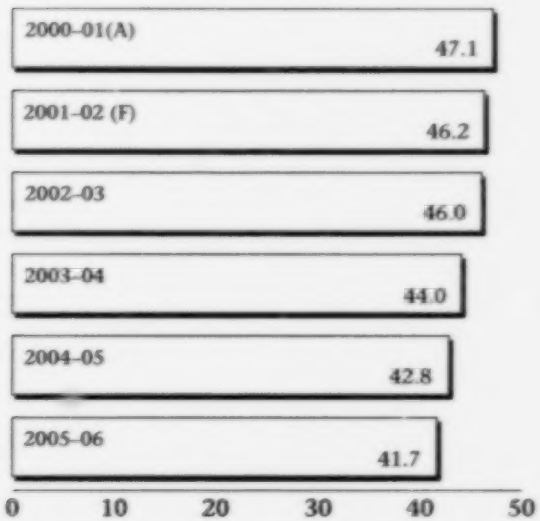
For the near term, revenue growth is expected to be relatively moderate. Longer term, development of the offshore and royalties from the offshore have the potential to raise growth rates and revenues to levels that would allow for further debt reduction. The recently released Energy Strategy identified a number of options in this regard. These options will be further developed and considered by government for inclusion in future fiscal plans.

The second, longer-term focus must be on improving the province's competitiveness relative to other provinces and within the world economy. Achieving financial sustainability is a critical component for improving competitiveness. As an overall measure of progress, the provincial government is projecting multi-year net direct debt to GDP ratios. These ratios are based on modest nominal economic growth ranging from 1 per cent to 5 per cent, and a constant level of capital spending. Graph 3 represents the projected net direct debt to GDP ratios.

Graph 3

Net Direct Debt to Gross Domestic Product Ratio 2000–01 to 2005–06

(percent)



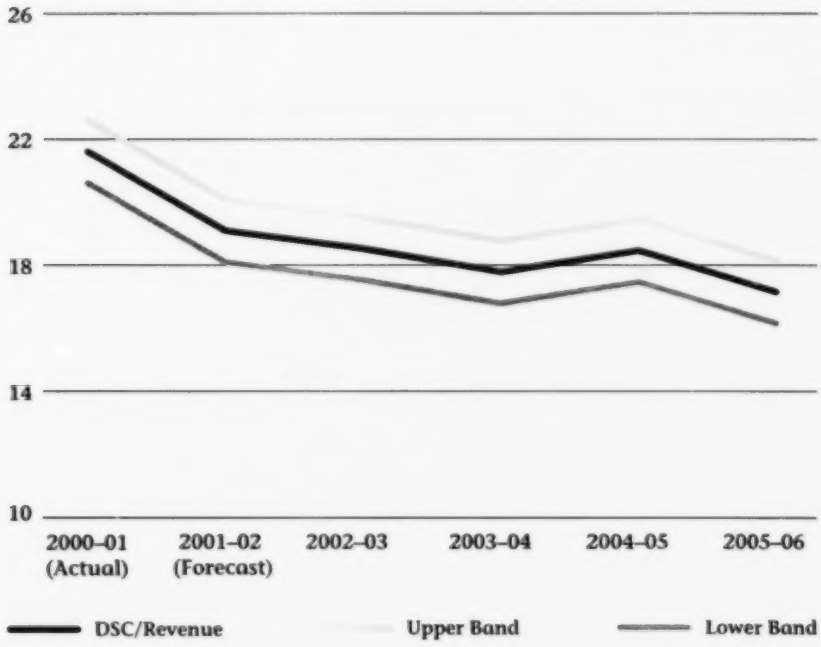
Source: Department of Finance Public Accounts and Budget Address 2002

The benefit of managing debt properly is more predictable debt-servicing costs. Tracking debt-servicing costs as a percentage of revenue shows the progress of government in managing debt and debt servicing. The ability to predict with certainty the absolute amount of debt-servicing costs is made difficult by the volatility of interest rates, length of maturity terms, type of interest rate (floating or fixed), and earnings from sinking funds. Because of this a band of reasonable variance is appropriate to allow for market volatility. Graph 4 shows the projected range of gross debt-servicing costs to revenue over the next four fiscal years.

Government has taken steps to lessen interest rate and market volatility. The province is well on its way to achieving its target of holding no more than 20 per cent of its debt in foreign currency. The percentage of foreign-owned currency at March 31, 2002 was 28.9 per cent, down from 72.2 per cent at March 31, 1995. The province will achieve its target of less than 20 per cent of debt held in foreign currency by September 2004. The government protects against interest rate swings through a policy that has established minimum and maximum range of holdings in floating interest rate instruments between 15 and 35 per cent of the total holdings.

Graph 4

Gross Debt Servicing Costs as a percentage of Revenue 2000–01 to 2005–06



Source: Department of Finance Public Accounts and Budget Address 2002, Schedule 16 (Note: revenue includes sinking fund earnings)

The final step will be to generate surpluses sufficient to begin to reduce debt. Paying down our debt can occur only if the province generates significant surpluses.

The central issue in this plan is prudent management of the province's finances through

- balanced budgets
- increased surpluses
- reduction in foreign held debt
- balanced approach to capital spending

The first and most important step has already been taken with the tabling of a balanced budget. The next step is to go beyond balanced budgets and deliver budgets with increasing surpluses. By achieving larger surpluses and applying the surpluses to the debt, the province will be able to reduce its level of debt, resulting in a reduction in the net direct debt to GDP ratio for the province. Net direct debt to GDP is one of the primary indicators of sustainability for a government. A lower net direct debt to GDP ratio will lead to lower debt-servicing costs, resulting in more flexibility for government to respond to the priorities of Nova Scotians.

For copies of this document and more information on the finances of the province, visit our website at <www.gov.ns.ca/finance>.